

## Internal Revenue Service

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Trust =  
Year 1 =  
Parent =  
Family Member 1 =  
Family Member 2 =  
Family Member 3 =  
Corporation A =  
Corporation B =  
Trustee A =  
Trustee B =  
Law Firm 1 =

State 1 =  
Spouse A =  
Child 1 =  
Child 2 =  
Child 3 =  
Child 4 =  
Child 5 =  
Child 6 =

Spouse B =  
Child 7 =  
Child 8 =  
Child 9 =  
Date 1 =  
State 2 =

Trust 1	=
Trust 2	=
Trustee C	=
Trustee D	=
Year 2	=
District Court	=
Appellate Court 1	=
Appellate Court 2	=
Appellate Court 3	=
Year 4	=
Year 3	=
Date 2	=
Trustee E	=
X	=
Y	=
Law Firm 2	=
Date 3	=
State 1 Law	=

Dear :

This is in response to a letter dated February 7, 2007, from your authorized representative, in which you request rulings concerning the income, gift, and generation-skipping transfer (GST) tax consequences of a proposed settlement agreement and proposed division of Trust.

### Facts

In Year 1, Parent created Trust, an irrevocable trust. Year 1 is prior to September 25, 1985.

Article 1.05(1) of Trust defines “issue” to mean all persons who are descended from the person referred to, either by legitimate birth to or legal adoption by the person referred to or any of the person’s legitimately born or legally adopted descendants.

Article 1.05(2) defines “child” to mean an issue of first generation.

Article 1.05(3) of Trust provides, in part, that the situs of the trust will be that state in which all the trustees acting under the trust agreement from time to time have their place of residence or, in the case of a corporate trustee, it has its principal place of business. If there are three or more trustees, then that state in which a majority of trustees have their place of residence or principal place of business will be the situs of the trust. Article 1.05(3) further provides that the rules of law and statutes of the state having situs of the trust from time to time will govern in all respects, except that the law

of State 1 will govern compliance with the requirements of execution of the trust agreement.

Article 3.02 of Trust provides that the payment of any principal or income may be made in the sole discretion of the trustees to qualified Charitable Beneficiaries (described in Article 3.03(2)) and/or to members of the lowest numbered class defined in Article 3.03(1) which at the time of payment has one or more living and otherwise eligible potential Individual Beneficiaries (described in Article 3.03(1)). Such payments among the members of a class of Individual Beneficiaries and Charitable Beneficiaries need not be equal either at the time of payment or at any future time and may be made to none, to one, to all or to any number of members of the class in any proportions both as between beneficiaries of the same class and as between Individual Beneficiaries and Charitable Beneficiaries, all as determined by the trustees, in their sole discretion. No potential Individual Beneficiary or Charitable Beneficiary will ever have any right, title, or interest in or claim to any part of the income or principal that could have been made unless and until actually received by the beneficiary.

Article 3.03 of Trust provides that payments of income or principal may be made to any one or more members of the lowest numbered of the classes of Individual Beneficiaries described in Article 3.03(1) that has one or more representative members then living and eligible to receive benefits and/or to any one or more members of the class of Charitable Beneficiaries described in Section 3.03(2).

Article 3.03(1) of Trust provides that the potential Individual Beneficiaries are separated into classes as follows: (i) Class One includes the then living issue, all spouses of the then living issue, and all spouses of the then deceased issue of Parent; (ii) Class Two includes the then living issue, all spouses of the then living issue, and all spouses of the then deceased issue of Family Member 1; (iii) Class Three includes the then living issue, all spouses of the then living issue, and all spouses of the then deceased issue of Family Member 2 and Family Member 3; (iv) Class Four includes the persons who would be determined to be the heirs-at-law of the last survivor of all members of Class One who leaves heirs then living or, if none, the heirs-at-law of the last survivor of all members of Class Two who leaves heirs then living or, if none, the heirs-at-law of the last survivor of all members of Class Three who leaves heirs then living, except that the heirs-at-law of spouses included in any of the classes are not eligible potential Individual Beneficiaries, and; (v) Class Five includes the employees, directors, and officers of Corporation A, Corporation B, or any subsidiary or successor corporations. Article 3.03(1)(vi) provides, in part, that in order for a spouse of a living issue to be considered a potential Individual Beneficiary, the spouse must then be living, married to and living with such issue, and, in the case of a spouse of a deceased issue, the spouse must have been married to and living with such issue at the time of such issue's death.

Article 3.03(2) of Trust describes the class of Charitable Beneficiaries.

Article 3.03(4) of Trust provides, in part, that the trustee has the power to make complete distribution of all the trust assets at any time, and in the event final distribution should be determined by the trustees or legally required, distribution will be made by the trustees to any or all members of the class of Individual Beneficiaries and Charitable Beneficiaries then eligible under the other provisions of Article 3, as determined by the trustees, in their sole discretion.

Article 4.01 of Trust provides, in part, that Trust is intended to endure in perpetuity, except as otherwise required by the governing law of Trust.

Article 5.01 of Trust provides, in part, that in the event Trustee A or Trustee B or any successor trustee to either of them ceases to serve, two partners of Law Firm will designate a successor who is a partner, associate, officer, director, or member of Law Firm or of any successor law firm (hereinafter a "member of Law Firm"). The power to designate will be exercised by two partners of Law Firm as often as there is a vacancy in the trusteeship originally filled by Trustee A or Trustee B so that, except as otherwise provided in Article 5.01 of Trust, a member of Law Firm will always be serving as trustee.

Article 5.01 further provides that certain classes of individuals or, alternatively if no such individuals exist, a court of competent jurisdiction, will have the following powers: to appoint one or more individual trustees and/or a corporate trustee to act with the trustee or trustees then acting; to remove the original and any successor trustees who are members of Law Firm; and, to nullify the further succession by any member of Law Firm. Specifically, these powers are exercisable by (i) the individual trustees or trustee (as distinguished from any corporate trustee) presently serving in such capacity; or (ii) if none, a majority of those potential Individual Beneficiaries who have not been adjudged incompetent or incapacitated, who have attained the age of thirty-five years, and who are members of the lowest-numbered class that contains any Individual Beneficiary as defined in Article 3.03(1) of Trust; or (iii) if none, a majority of the potential Individual Beneficiaries who have not been adjudged incompetent or incapacitated, who have attained the age of majority, and who are members of the lowest-numbered class that contains any Individual Beneficiary as defined in Article 3.03(1) of Trust; or (iv) if none, a court of competent jurisdiction in the then state of situs of the trust, or if no trustee is acting, a court of competent jurisdiction in the state of situs of the trust at the time of failure of the last remaining trustee.

Article 5.04(9) of Trust provides the trustees of Trust with the authority to divide the trust, determining values and designating particular assets for the beneficiaries, to assign like or unlike properties to different beneficiaries or trusts, to create or hold undivided interests in any property of the trust, and to make distributions and payments in cash or in kind or in both. Article 5.04(15) of Trust further provides the trustees of Trust with the authority to compromise, settle, and adjust all claims and problems of any

kind and to perform all other acts that they deem necessary or advisable for the complete administration of the trust.

At the creation of Trust, Parent was married to Spouse A and had six children: Child 1, Child 2, Child 3, Child 4, Child 5, and Child 6 (the “Older Children”). Subsequent to the creation of Trust, Parent married Spouse B. Three children, namely, Child 7, Child 8, and Child 9 (the “Younger Children”), were born to Spouse B during the marriage. A final judgment of dissolution of the marriage of Parent and Spouse B was entered on Date 1 in State 2. Prior to the dissolution of the marriage and prior to the birth of Child 9, Parent raised the issue of whether Child 7 and Child 8 were his biological children. Nevertheless, in an agreement incorporated into the final judgment of dissolution of marriage, Parent conceded that the Younger Children were children of the marriage and agreed that, with respect to any testamentary disposition, the Younger Children would share equally and no differently than Parent’s children from prior or future marriages.

The current trustees of Trust, Trustee C and Trustee D, are members of Law Firm, appointed in accordance with the successor trustee provisions in Article 5 of Trust. Trust has been administered under the laws of State 1 since inception in accordance with the situs and choice of law provisions in Article 1 of Trust. Presently, the lowest numbered class of Individual Beneficiaries described in Article 3.03(1) of Trust that has one or more representative members then living and eligible to receive benefits is Class One. The assets of Trust consist of cash, marketable securities, and equity interests in closely-held corporations, partnerships, and other business organizations. The trustees represent that there have been no actual or constructive additions to Trust since September 25, 1985.

Litigation began in Year 2 when the trustees of Trust petitioned District Court in State 1 (the “Year 2 Petition”) for an order determining the proper beneficiaries of Trust. The trustees moved for a summary judgment declaration that only biological and legally adopted children of Parent are considered “issue” of Parent. The Younger Children moved for a summary judgment declaration that Younger Children are considered potential Individual Beneficiaries of Class One. The Older Children filed documents in support of the trustees’ position. District Court granted the trustees’ motion for summary judgment. Appellate Court 1 reversed District Court and ordered that summary judgment be entered in favor of the Younger Children, concluding that State 1 Law did not authorize the trustees to collaterally attack the younger children’s parentage previously adjudicated in State 2. The trustees’ petitions for review to Appellate Court 2 and Appellate Court 3 were summarily denied.

Additional litigation followed with regard to the reimbursement of attorney fees and expenses that the Younger Children and the Older Children incurred in relation to the Year 2 Petition. In separate orders, District Court awarded both parties the

reimbursement requested. After an appeal to Appellate Court 1, this litigation was concluded by Year 4.

In Year 3, the Younger Children petitioned District Court in State 1 (the “Year 3 Petition”) requesting an order (a) requiring Trustee C and Trustee D to allow counsel for the Younger Children to inspect and copy all documents relating to the administration of Trust; (b) imposing personal liability on Trustee C and Trustee D for attorney fees and expenses that the trustees charged against the trust assets in connection with the identity of the beneficiaries of Trust; (c) imposing personal liability on Trustee C and Trustee D for any and all attorney fees the trustees charged against the trust assets in connection with proceedings on the Year 3 petition; (d) charging against the trust assets the reasonable attorney fees and expenses incurred by the Younger Children in proceedings on the Year 3 Petition; (e) removing Trustee C and Trustee D as trustees of Trust and directing that all successors to such trustees will be appointed by District Court; and (f) appointing an independent, institutional trustee as successor to Trustee C and Trustee D.

After the filing of the Year 3 Petition, the parties to the litigation engaged in substantial discovery and motion practice over a period of 19 months before agreeing to mediate the ongoing dispute. District Court appointed a guardian ad litem to represent the interests of the minor children of the Older Children and any other unborn or unascertained person who might claim an interest in Trust by or through a relationship to the Older Children or their respective issue and appointed a second guardian ad litem to represent the interests of the potential future respective spouses, issue, and spouses of issue of the Younger Children, and any unborn or unascertained person who may claim an interest in Trust by or through a relationship to the Younger Children or their respective issue. Shortly before trial was scheduled to commence on the issues included in the Year 3 Petition, the parties ultimately agreed to, and the guardians ad litem consented to, a final “Settlement Agreement and Release” (hereinafter, the “Agreement”) in which Trust would be divided into two trusts, one for the benefit of Older Children and one for the benefit of Younger Children, with certain modifications as provided in the incorporated trust agreements. The Agreement was approved by order of District Court on Date 2, contingent on the issuance by the Internal Revenue Service of a favorable private letter ruling with respect to the income, gift, and GST tax consequences of the proposed division and modification of Trust.

Pursuant to the Agreement, Trust will be divided into two trusts, Trust 1 and Trust 2. Trust 1 will be administered by Trustee C and Trustee D (the current trustees of Trust) for the primary benefit of the Older Children and the other members of their respective family lines pursuant to the Trust 1 trust agreement. Trust 2 will be administered by Trustee E (as the original trustee) for the primary benefit of the Younger Children and the other members of their respective family lines pursuant to the Trust 2 trust agreement. Trust 1 will be allocated X percent of the assets and liabilities of Trust and Trust 2 will be allocated Y percent of the assets and liabilities of Trust. All assets and

liabilities will be allocated on a pro rata basis provided that (a) if necessary, the number of shares of common stock of closely-held Corporation A that are allocated to Trust 1 will be rounded up to the nearest whole number and number of shares allocated to Trust 2 will be rounded down to the nearest whole number and (b) all shares or other interests in closely-held Corporation B owned by Trust will be allocated to Trust 1 and additional cash will be allocated from Trust to Trust 2 to the extent necessary to provide Trust 2 with Y percent of the assets of Trust. In allocating assets, the trustees will allocate assets in a manner that is fairly representative of the unrealized appreciation and depreciation of the assets as of the effective date of the Agreement.

The Agreement also provides that legal and professional fees will be apportioned as follows: (1) the fees of Trustee C and Trustee D and the fees of any guardian ad litem appointed by District Court incurred in connection with the proceedings pertaining to the Year 3 petition will be paid from the assets of Trust, prior to division; (2) the fees of the Older Children will be paid from the assets of Trust 1; and (3) the fees of the Younger Children will be paid from the assets of Trust 2.

Upon division of Trust into Trust 1 and Trust 2 pursuant to the Agreement, the terms of Trust 1 and Trust 2 will be modified from the original terms of Trust as follows:

A definition of "Older Children," "Younger Children," and "Family Line" are added to the trust agreements of Trust 1 and Trust 2. Article 1.05(3) of Trust 1 and Trust 2 provides that "Older Children" of Parent include Child 1, Child 2, Child 3, Child 4, Child 5, and Child 6. Article 1.05(4) of Trust 1 and Trust 2 provides that "Younger Children" of Parent include Child 7, Child 8, and Child 9. Article 1.05(5) of Trust 1 and Trust 2 provides that "Family Line" of a child of Parent means such child of Parent, the spouse of such child of Parent, the issue of such child of Parent and the respective spouses of the issue of such child of Parent.

Article 1.05(3) of Trust is now Article 1.05(6) of Trust 1 and Trust 2 and it is modified in that it provides that the rules of law and statutes of State 1, regardless of the state that may be the situs of the trust from time to time, will govern in all respects.

The potential Individual Beneficiaries described in Article 3.03(1)(i) of Trust 1 and Trust 2 are modified from those originally described in Article 3.03(1)(i) of Trust. Pursuant to Article 3.03(1)(i) of Trust 1, Class One includes the then living Older Children, the then living issue of the Older Children, the then living spouses of the then living Older Children, the then living spouses of the then deceased Older Children, the then living spouses of the then living issue of the Older Children, and the then living spouses of the deceased issue of the Older Children. Pursuant to Article 3.03(1)(i) of Trust 2, Class One includes the then living Younger Children, the then living issue of the Younger Children, the then living spouses of the then living Younger Children, the then living spouses of the then deceased Younger Children, the then living spouses of the

then living issue of the Younger Children, and the then living spouses of the deceased issue of the Younger Children.

A new provision is included as Article 3.03(4) of Trust 1 and Trust 2. Article 3.03(4) of Trust 1 provides that upon the termination of the Family Line of an Older Child, if there is then any continuing Family Line of a Younger Child, the trustees, effective as of the division date, will allocate a share of the trust to the terminated family line of an Older Child by dividing the assets of the trust into so many equal fractional shares as there are continuing Family Lines of the Older Children plus one. The share allocated to a terminated Family Line of an Older Child will be further divided into so many equal fractional shares so that there will be one share allocated to each continuing Family Line of a child of Parent. Any shares of a terminated Family Line of an Older Child allocated to the continuing Family Lines of the Older Children will continue to be aggregated, held, and administered pursuant to Article 3 of Trust 1. Any shares of a terminated Family Line of an Older Child allocated to the continuing Family Lines of the Younger Children will be distributed to the then acting trustee under Trust 2. With respect to Trust 2, Article 3.03(4) of Trust 2 similarly provides that upon the termination of the Family Line of a Younger Child, if there is then any continuing Family Line of an Older Child, the trustees, effective as of the division date, will allocate a share of the trust to the terminated family line of a Younger Child by dividing the assets of the trust into so many equal fractional shares as there are continuing Family Lines of the Younger Children plus one. The share allocated to a terminated Family Line of an Younger Child will be further divided into so many equal fractional shares so that there will be one share allocated to each continuing Family Line of a child of Parent. Any shares of a terminated Family Line of a Younger Child allocated to the continuing Family Lines of the Younger Children will continue to be aggregated, held, and administered pursuant to Article 3 of Trust 2. Any shares of a terminated Family Line of a Younger Child allocated to the continuing Family Lines of the Older Children will be distributed to the then acting trustee under Trust 1.

Trust 1 retains the substantive provisions of Article 5.01 of Trust. Article 5.01 of Trust 2 retains the substantive provisions of Article 5.01 of Trust except that Article 5.01 of Trust 2 does not contain any reference to appointing members of Law Firm as successor trustees. Trust 2 includes new provisions in Article 5.02 relating to a "Qualified Corporate Trustee," which is a trust company or banking association with a national charter having trust powers and having at least one billion dollars under administration. Article 5.02(1) of Trust 2 provides a definition of "Qualified Corporate Trustee." Article 5.02(2) of Trust 2 provides that one Qualified Corporate Trustee is required to be serving as trustee at all times. Article 5.02(3) of Trust 2 provides that if one or more individual trustees are acting under this agreement, a majority of the individual trustees will have the power to remove or replace a Qualified Corporate Trustee and will have a duty to appoint another Qualified Corporate Trustee in its place. If there are no individual trustees acting under the agreement, Article 5.02(3) of Trust 2 provides that a partner, member, or shareholder of Law Firm 2 or an attorney with



certain qualifications (as designated in writing by two partners, members, or shareholders of Law Firm 2) will have the power to remove or replace a Qualified Corporate Trustee and will have a duty to appoint another Qualified Corporate Trustee.

A new provision is included in Trust 2 as Article 5.06. Article 5.06(1) of Trust 2 provides that the trustee owning directly or indirectly any shares of common or preferred voting stock of Corporation A will exercise all voting rights in respect to the Corporation A shares only in accordance with the written instructions of the trustees of Trust 1. Article 5.06(2) of Trust 2 provides that if any Corporation A shares are distributed or transferred to any beneficiary or other person, the trustee will first require such distributee to deliver to the trustees of Trust 1 an irrevocable proxy conferring upon the trustees of Trust 1 the right to exercise all voting rights in respect to such shares. Article 5.06(4) of Trust 2 provides that Articles 5.06(1) and (2), including any irrevocable proxy delivered thereunder, will be ineffective after Date 3.

You now request the following rulings:

1. The implementation of the Agreement and the division of Trust pursuant thereto will not cause Trust or the resulting subtrusts to lose exempt status under § 1433(b)(2)(A) of the Tax Reform Act of 1986 and § 26.2601-1(b)(4)(i) of the Generation-Skipping Transfer Tax Regulations.
2. The implementation of the Agreement and the division of Trust pursuant thereto will not create a transfer of property that is subject to federal gift tax under § 2501.
3. No gain or loss will be recognized for purposes of § 61 or § 1001 as a result of the division of Trust.

#### Ruling 1

Section 2601 of the Internal Revenue Code imposes a tax on every GST, which is defined under § 2611 as a taxable distribution, a taxable termination, or a direct skip.

Under § 1433 of the Tax Reform Act of 1986 (the Act), GST tax is generally applicable to GSTs made after October 22, 1986. However, under § 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the tax does not apply to a transfer under a trust that was irrevocable on September 25, 1985, except to the extent the transfer is made out of corpus added to the trust by an actual or constructive addition after September 25, 1985.

Section 26.2601-1(b)(4)(i) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the GST tax under § 26.2601-1(b) will not cause the trust to lose its exempt status. These rules are applicable only for purposes of determining whether an exempt trust retains exempt status for GST tax purposes. The rules do not apply in

determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of capital gain for purposes of § 1001.

Section 26.2601-1(b)(4)(i)(B) provides that a court-approved settlement of a bona fide issue regarding the administration of the trust or the construction of terms of the governing instrument will not cause an exempt trust to be subject to chapter 13 if (1) the settlement is the product of arm's length negotiations; and (2) the settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement. A settlement that results in a compromise between the position of the litigating parties and reflects the parties' assessments of the relative strengths of their positions is a settlement that is within the range of reasonable outcomes.

In this case, Trust was irrevocable on September 25, 1985. Further, it is represented that there have been no actual or constructive additions to Trust after September 25, 1985. Accordingly, Trust is exempt from GST tax under § 26.2601-1(b)(1).

The terms of the Agreement, including the proposed division of Trust and each of the proposed modifications to Trust, are the result of a settlement of numerous issues between the Older Children, the Younger Children, and the Trustees. The litigation between the parties has been ongoing since the Year 2 Petition, a period of over 7 years. The issues have been tenaciously litigated, including multiple appeals. Shortly before trial was scheduled to commence on the issues included in the most recent petition, the Agreement averted the need for a trial. We conclude that the Agreement constitutes a settlement of bona fide issues regarding the administration of Trust and regarding the construction of the terms of Trust. We also conclude that the terms of the Agreement, including the proposed division of Trust and each of the proposed modifications to Trust, are the product of arm's length negotiations and represent a compromise between the positions of the parties and reflect the parties' assessments of the relative strengths of their positions. We further conclude that the Agreement is within the range of reasonable outcomes under the governing instrument and the applicable law of State 1 addressing the issues resolved by the Agreement.

Accordingly, based upon the facts submitted and the representations made, we rule that the division and modification of Trust, as provided, will not cause Trust, Trust 1, or Trust 2 to lose its status as exempt from the application of the federal GST tax by reason of the effective date rule contained in § 1433(b)(2) of the Act and the application of § 26.2601-1(b)(4)(i)(B) of the Generation-Skipping Transfer Tax Regulations.

## Ruling 2

Section 2501(a) provides that a tax is imposed for each calendar year on the transfer of property by gift during such calendar year.

Section 2511(a) provides that the gift tax applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect and whether the property is real or personal, tangible or intangible.

Section 25.2511-1(b) of the Gift Tax Regulations provides that, as to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him or her no power to change its disposition, whether for his or her own benefit or for the benefit of another, the gift is complete. But, if upon a transfer, a donor reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the fact in the particular case.

Section 25.2511-1(c)(1) provides that any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to tax.

Whether an agreement settling a dispute is effective for gift tax purposes depends on whether the settlement is based on a valid enforceable claim asserted by the parties and, to the extent feasible, produces an economically fair result. See Ahmanson Foundation v. U.S., 674 F.2d 761, 774-75 (9<sup>th</sup> Cir. 1981), citing Commissioner v. Estate of Bosch, 387 U.S. 456 (1967). Thus, state law must be examined to ascertain the legitimacy of each party's claim. If it is determined that each party has a valid claim, the Service must determine that the distribution under the settlement reflects the result that would apply under state law. If there is a difference, it is necessary to consider whether the difference may be justified because of the uncertainty of the result if the question were litigated.

As discussed above, the Agreement represents the resolution of a bona fide controversy between the parties. The proposed settlement is a mediated settlement and is based on arm's length negotiations among all the interested parties. All interested parties who hold or may hold an interest in Trust, including any minors and unborn heirs, have been represented in the negotiations that preceded the Date 2 order approving the Agreement.

The terms of the Agreement, including the proposed division of Trust and each of the proposed modifications to Trust, are the result of a settlement of numerous issues between the Older Children, the Younger Children, and the Trustees. We conclude that the Agreement is reflective of the rights of the parties under the applicable law of State 1 that would be applied by the highest court of State 1. Accordingly, based on the facts submitted and representations made, we conclude that the Date 2 order of District Court adopting the terms of the Agreement will not cause any of the beneficiaries to have made a taxable gift for purposes of the federal gift tax under § 2501.

### Ruling 3

Section 61(a)(3) provides that gross income includes gains derived from dealings in property.

Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in § 1011 for determining gain, and the loss is the excess of the adjusted basis provided in § 1011 for determining loss over the amount realized. Under § 1001(c), the entire amount of gain or loss must be recognized, except as otherwise provided.

Section 1.1001-1(a) of the Income Tax Regulations provides that, except as otherwise provided in subtitle A of the Code, the gain or loss realized from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.

Rev. Rul. 56-437, 1956-2 C.B. 507, provides that a partition of jointly owned property is not a sale or other disposition of property where the co-owners of the joint property sever their joint interests, but do not acquire a new or additional interest as a result of the transaction. Thus, neither gain nor loss is realized on a partition.

In Rev. Rul. 69-486, 1969-2 C.B. 159, a non-pro rata distribution of trust property was made in kind by the trustee, although the trust instrument and local law did not convey authority to the trustee to make a non-pro rata distribution of property in kind. The distribution was a result of a mutual agreement between the trustee and the beneficiaries. Because neither the trust instrument nor local law conveyed authority to the trustee to make a non-pro rata distribution, Rev. Rul. 69-486 held that the transaction was equivalent to a pro rata distribution followed by an exchange between the beneficiaries, an exchange that required recognition of gain under § 1001.

The law of State 1 authorizes a trustee on distribution of trust property or the division or termination of a trust, to make distributions in divided or undivided interests, allocate particular assets in proportionate or disproportionate shares, value the trust property for those purposes, and adjust for resulting differences in valuation.

In Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991), the Supreme Court concluded that an exchange of property results in the realization of gain or loss under § 1001 if the properties exchanged are materially different. Properties exchanged are materially different if the properties embody legal entitlements “different in kind or extent” or if the properties confer “different rights and powers.” Id. at 565. In Cottage Savings, the Court held that mortgage loans made by different obligors and secured by different homes did embody distinct legal entitlements, and that the taxpayer realized losses when it exchanged interests in the loans. Id. at 566. In defining what constitutes a “material difference” for purposes of § 1001(a), the Court stated that properties are

“different” in the sense that is “material” to the Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent. Id. at 564-65.

The practical effect of the Agreement is to sever the respective interests of the Older Children and the Younger Children. The respective interests of the Older Children and the Younger Children (and their respective family lines) in Trust are entirely discretionary; no beneficiary has an entitlement to the distribution of any particular income or assets from Trust at any time. The trust division and distribution pursuant to the Agreement is equivalent to and consistent with a division and distribution made by the trustees pursuant to their power of discretionary distributions and within the applicable law of State 1. Upon division and distribution, neither the Older Children nor the Younger Children (nor their respective family lines) will acquire any new or additional interests.

In the present case, the Older Children and the Younger Children are severing their respective interests under Trust. However, because the trust agreement of Trust and the law of State 1 authorize non-pro rata divisions, the proposed trust division of Trust into Trust 1 and Trust 2 will not result in the Older Children or the Younger Children acquiring any new or additional interests. Therefore, under Rev. Rul. 56-347, the division of Trust is not a sale or other disposition of property and does not result in a material difference in the legal entitlements enjoyed by the beneficiaries under Cottage Savings. Accordingly, no gain or loss is recognized on the division of Trust for purposes of § 1001.

In addition, the present case is distinguishable from Rev. Rul. 69-486. Unlike the disguised transaction situation presented in the revenue ruling, here the trust agreement and the law of State 1 authorizes non-pro rata divisions. Accordingly, the proposed division will not be treated as a pro rata distribution followed by an exchange of assets among the beneficiaries of the original trust.

We rule that the proposed division of Trust will not constitute a taxable disposition under § 1001.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

James F. Hogan  
Senior Technician Reviewer, Branch 4  
Office of the Associate Chief Counsel  
(Passthroughs & Special Industries)

cc: